UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re:	Chapter 7 Case
SRC Holdings Corporation, f/k/a Miller & Schroeder, Inc. and its subsidiaries,	BKY Case Nos. 02-40284 to 02-40286 Jointly Administered
Debtor.	
Brian F. Leonard, Trustee,	ADV Case No. 03-4284
Plaintiff,	
v.	
Executive Risk Indemnity, Inc.	
Defendant.	
The Marshall Group, Inc., Jerome A. Tabolich, James E. Iverson, Edward J. Hentges, Kenneth R. Larsen, Steven W. Erickson, Paul R. Ekholm, and Mary Jo Brenden,	
Intervenors.	

AMENDED NOTICE OF HEARING AND MOTION FOR PARTIAL SUMMARY JUDGMENT

To: Entities Specified in Local Rule 9013-3

1. Brian F. Leonard, Trustee, and Plaintiff herein (**"Plaintiff"**), by and through his undersigned attorneys, moves the Court for the relief requested below and gives notice of hearing.

2. The Court will hold a hearing on this motion at 10:30 a.m. on December 16, 2004,

before the Honorable Nancy C. Dreher, in Courtroom 7, U.S. Courthouse, 300 South Fourth Street, Minneapolis, Minnesota.

3. Any response to this Motion must be filed and delivered no later than November 12, 2004 which is thirty-four (34) days before the time and date set for the hearing, or mailed and filed by November 9, 2004 which is thirty-seven (37) days prior to the hearing. **UNLESS A RESPONSE OPPOSING THE MOTION IS TIMELY FILED, THE COURT MAY GRANT THE MOTION WITHOUT A HEARING.**

4. This Court has jurisdiction over this Motion pursuant to 28 U.S.C. §§ 157 and 1334, Fed. R. Bankr. P. 5005 and Local Rule 1070-1. This proceeding is a core proceeding. The complaint commencing this adversary proceeding was filed on October 1, 2003. The case is now pending in this court.

5. This Motion arises under Bankruptcy Rule 7056 and Local Rule 9013. This Motion is filed under Bankruptcy Rule 9014 and Local Rules 7007-1, 9006-1, 9013-1, 9013-2 and 9017-1. Movant requests an order granting Plaintiff's partial summary judgment on all Counts in this matter.

6. This Motion is based upon the attached Memorandum of Law in Support of Motion for Summary Judgment, Affidavit of Thomas C. Atmore, and upon the files, records and proceedings herein, as well as the arguments of counsel.

WHEREFORE, Plaintiff requests that the Court enter an Order as follows:

1. Granting Plaintiff partial summary judgment declaring that the subject insurance policy provides coverage for the "Heritage Bond" claims; and

2. For such other relief as is just and equitable.

LEONARD, O'BRIEN
SPENCER, GALE & SAYRE, LTD.

Dated: October 30, 2004

By /e/ Thomas C. Atmore
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In re:	Chapter 7 Case
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Debtor.	
Brian F. Leonard, Trustee,	ADV Case No. 03-4284
Plaintiff,	
v.	**PLAINTIFF'S AMENDED MEMORANDUM IN SUPPORT OF MOTION FOR PARTIAL SUMMARY JUDGMENT**
Executive Risk Indemnity, Inc.	
Defendant.	
The Marshall Group, Inc., Jerome A. Tabolich, James E. Iverson, Edward J. Hentges, Kenneth R. Larsen, Steven W. Erickson, Paul R. Ekholm, and Mary Jo Brenden,	
Intervenors.	

INTRODUCTION

The Heritage Bond claims made against Miller & Schroeder and its officers and directors fall squarely within the coverage afforded by the policy and, in particular, Endorsement No. 9.

Plaintiff is entitled to summary judgment on his request that the Court declare that the policy

provides coverage for the Heritage Bond claims.[1]

When this case began, Executive Risk Indemnity, Inc. ("Executive Risk") responded to the Complaint by filing a motion to dismiss on the grounds that the "Securities Exclusion" precluded coverage. At the hearing on the motion, the Court asked counsel for each side to discuss the underlying insurance policy in its entirety and explain whether coverage would or would not be available for the Heritage Bond claims. Executive Risk chose to focus on the "Securities Exclusion" and did not fully address the other endorsement at issue, Endorsement No. 9 the "General E&O Exclusion (with Management Carveback)." Now, after extensive discovery has been conducted and the depositions of Executive Risk'S claims examiners have been taken, the reason why Executive Risk avoided Endorsement No. 9 and sought to focus attention on the Securities Exclusion has become clear. Executive Risk's position on Endorsement No. 9, and its interaction with the Securities Exclusion, has changed over time. It was not until Executive Risk realized that it would be faced with paying out the entire limit of the policy that it decided that Endorsement No. 9, and its management carveback, could never provide coverage. Executive Risk's interpretation of Endorsement No. 9, however, defies logic and is contrary to the plain language of the endorsement. Executive Risk's internal

communications, as opposed to its current position, moreover, establish that the intent of the

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[1] The purpose of the present motion is to establish that there is coverage for the claims. The next step, allocation of that coverage, is an issue that remains for resolution once coverage is established.

carveback was to provide coverage for claims like those made the Heritage Bond bondholders.[2]

FACTUAL BACKGROUND

The facts are undisputed, but a detailed recitation is necessary to an understanding of the insurance policy at issue and why it provides coverage.

A. MI Acquisition Corp. Purchases the Policy in 1997

In 1997, MI Acquisition Corporation, headed by James Dlugosch, purchased the stock of Miller & Schroeder, Inc. and took over the company and its subsidiaries. Ex. A (Deposition of James F. Dlugosch) to Affidavit of Thomas C. Atmore at 19-20.[3] Mr. Dlugosch and the other directors considered it important to have insurance protection for the officers and directors of the company. *Id*. at 36-37. The purpose in obtaining the insurance was to protect the officers and directors from suits by customers. *Id*. at 37. MI Acquisition used The Hays Group, a retail insurance broker; The Hays Group worked through a wholesale broker, ARC Excess and Surplus ("ARC"); and one of ARC's principals, Richard Fierstein, contacted Executive Risk. Ex. B (Deposition of Richard Fierstein) at 22-24, 28-31. ARC was Executive Risk's agent. *Id*. at 24.

Michael Watts, the Executive Risk underwriter, worked with Mr. Fierstein in negotiating

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[2] Both sets of intervenors have also moved for summary judgment on the issue of coverage. Although the parties' interests may diverge after coverage is declared and the focus turns to the allocation of the limited coverage, Plaintiff joins in and adopts the arguments of the Intervenors regarding coverage.

[3] With two exceptions, all exhibits are attachments to the Atmore Affidavit. Reference will only be made to the exhibit letter, the deponent or deposition exhibit (if applicable), and the page(s) of the exhibit, rather than repeatedly reciting that the exhibits are attached to the affidavit. The exceptions will be clearly identified.

the terms of the D&O policy. Neither Mr. Watts nor Mr. Fierstein could recall any details of the transaction. *Id*. at 31; Ex. C (Deposition of Michael Watts) at 36.

Executive Risk, after receiving an application and other information via The Hays Group and ARC, submitted a proposal to ARC. Ex. D (Watts Dep. Ex. 5). Executive Risk's D&O policy was called The POWER. Ex. E (Watts Dep. Ex. 1). According to Mr. Fierstein, a D&O policy like The POWER was intended to cover a variety of claims, including customer lawsuits. Ex. B (Fierstein Dep.) at 8. There were a number of standard endorsements to the policy, including the securities exclusion and the general E&O exclusion. Ex. C (Watts Dep.) at 21-22. The securities exclusion was intended to preclude claims made against the insureds arising out of sales of the insured company's stock. In fact, Mr. Fierstein testified that the understanding in the insurance industry is that a "Securities Exclusion" is designed to exclude coverage for claims arising from an insured's Initial Public Offering. Ex. B (Fierstein Dep.) at 42-43. The general E&O exclusion, meanwhile, was intended to preclude coverage for errors and omissions type liability, but, of course, in the present case the endorsement included a "management carveback."

There was limited negotiation of the terms and scope of the endorsements. First, the parties added an endorsement that allowed coverage for any claims that might arise out of a specific private placement of Miller & Schroeder stock in May of 1997. Ex. E (Watts Dep. Ex. 1). Second, as to the E&O exclusion, the parties changed it from a general, broad exclusion to one that listed the specific services that were subject to the exclusion and also included the "management carveback," bringing back into coverage claims against an insured based upon the alleged failure to supervise any subsidiary, group or division. Ex. F (Watts Dep. Ex. 7).

Executive Risk agreed to bind coverage and then issued a policy. *Id*., and Ex. G (Watts Dep. Ex.11).

The 1997 policy was effective from July 1997 to July 2000, when it was renewed, without substantive change, for another three years. Ex. H. In 1999, however, Executive Risk was purchased by Chubb Insurance Group. Ex. C (Watts Dep.) at 57-58. Mr. Watts left the company. *Id*.

Mr. Dlugosch and Tom Nelson, the two people involved in obtaining the policy on behalf of MI Acquisition Corp., both testified that they understood the policy, and in particular the "management carveback," to provide coverage for claims like those made by the Heritage Bondholders. Ex. A (Dlugosch Dep.) at 47-48 and Ex. I (Deposition of Tom Nelson) at 57.

B. <u>The Policy</u>[4]

The renewed POWER "Directors and Officers Liability Insurance Policy" (the "Policy") was in effect from July 31, 2000 to July 31, 2003. Ex. H at p. 1. The "Parent Corporation" listed on the Declarations is "Miller & Schroeder, Inc." *Id*. Miller & Schroeder, Inc. paid for coverage for claims made against officers and directors and for claims made against the insured companies (the latter is referred to as "Insuring Agreement (B)(2)"). *Id*. *See also* Section I of the Policy. *Id*. at p. 3. The liability limit is $5,000,000, inclusive of defense costs, and there are retentions of $50,000 for Company indemnification and $100,000 for claims directly against the Company. *Id*. at p. 1. The Policy is a "claims made" Policy, meaning that it provides coverage if the claim is first made during the Policy period. *Id*.

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[4] This section is taken virtually verbatim from Plaintiff's Response to Executive Risk's Motion to Dismiss.

The "Insuring Agreement" provides, in relevant part:

> (B) The Underwriter will pay on behalf of the **Company**:
>
> (1) **Loss** from **Claims** first made against the **Insured Persons** during the **Policy Period** for **Wrongful Acts**,...if the **Company** pays such **Loss** to or on behalf of the **Insured Persons** as indemnification; and
>
> (2) (OPTIONAL COVERAGE) if it is stated in the Declarations that coverage has been made available under this INSURING AGREEMENT (B)(2), **Loss** from **Claims** first made against the **Company** during the **Policy Period** for **Wrongful Acts**,...
>
> (C) As a part of and subject to the limit of liability stated in ITEM 3 of the Declarations, the Underwriter will have the right and duty to defend any **Claim** as described in INSURING AGREEMENTS (A) and (B)(1)(and, if it is stated in the Declarations that coverage has been made available thereunder, INSURING AGREEMENT (B)(2)), even if such **Claim** is groundless, false or fraudulent.

Id. at ¶ I, p. 3 (bold in original; underline supplied). Executive Risk, then, agreed to both pay any covered loss and defend its insureds against any covered claims.

The terms in bold above are defined terms in the Policy. The "**Company**" is defined as Miller & Schroeder, Inc. and its subsidiaries. *Id*. at II(C), p. 4 "**Insured**" means the **Company** and any "**Insured Person**." *Id*. at II(F), p. 4. An **Insured Person** is, for purposes of the subject claims, "any past, present or future director or officer of the **Company**..." *Id*. at II(G)(1), p. 4.

"**Loss**" is defined as any defense expenses and any "damages, judgments, settlements or other amounts" that the insured has to pay as a result of a **Claim**. *Id*. at II(H), p. 5. A "**Wrongful Act**" is, for our purposes, defined as "any actual or alleged act, error, omission, misstatement, misleading statement or breach of duty by an **Insured Person** in his or her capacity as a director or officer of the **Company**...." and "any matter asserted against an **Insured Person** solely by reason of his or her status as a director or officer of the **Company**..." *Id*. at

II(M)(2) and (3), p. 5.

The "Securities Exclusion" attempts to exclude from coverage any claims brought under Federal and State securities laws and any common law relating to the "offer, sale or purchase of securities." *Id*. The exclusion carefully lists the "Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, any other federal law, rule or regulation with respect to the regulation of securities, any rules or regulations of the United States Securities and Exchange Commission...." *Id*. at ¶(1). Note that the rules and regulations of the National Association of Securities Dealers are **not** listed, nor are the rules of the Municipal Securities Regulation Board.

The "Securities Exclusion" is modified by "Endorsement No. 6 Limited Securities Coverage Endorsement" which allows coverage for any claims arising out of the "offering, sale or purchase" made in a "Private Placement" of stock that occurred on May 20, 1997. *Id*. at p. 21.

The final "endorsement" of relevance to the present case is "Endorsement No. 9 General E & O Exclusion (with Management Carveback)." *Id*. at p. 25. This exclusion provides that there is no coverage for claims against an insured based on the "actual or alleged rendering or failure to render" certain listed services. *Id*. at ¶(1). The services listed are: "Investment Banking Services, Securities Broker/Dealer Services, Securities Underwriting." *Id*. The exclusion is limited by a "management carveback," that provides coverage for claims arising out of the listed services made against "an Insured to the extent such Claim is for a Wrongful Act by Insured Person in connection with the management or supervision of any division, Subsidiary or group of the Parent Corporation offering any of the aforementioned services." *Id*. at ¶(2).

C. <u>The Heritage Bonds</u>

The present dispute arises out of Executive Risk's refusal to provide a defense, provide coverage, or reimburse defense costs incurred by Miller & Schroeder in defending what has come to be known as the "Heritage Bond Litigation."

The Solano Beach office of Miller & Schroeder Financial, Inc. underwrote and sold $140,000,000 worth of bonds, all of which were defaulted upon. Miller & Schroeder customers lost anywhere from thousands to millions of dollars and initiated suits and arbitration proceedings naming the Miller & Schroeder entities, the employees who handled the bond sales, and the various officers and directors of Miller & Schroeder.

The majority of the claims were asserted in NASD arbitration proceedings. *See e.g.*, Exs. 4 and 5 to the Affidavit of John M. Anderson dated November 14, 2003 and on file herein. Miller & Schroeder, Inc. and/or Miller & Schroeder Financial, Inc. were named in virtually every arbitration, as were a variety of officers and directors, whether or not they had any direct participation in the bond sales. *Id*. They were also named because they served on the Credit Committee that had a supervisory role over the underwriter selling the bonds. Ex. I (Nelson Dep.) at 38-40, 63.

The NASD arbitrations involve claims that Miller & Schroeder violated NASD rules, including the rule requiring that Miller & Schroeder properly supervise its brokers. *See e.g.*, Ex. J. The NASD rules also provide that investments recommended to customers must be suitable for that customer and his or her goals and circumstances. *Rule 2310 of NASD Rules*. The Heritage Bond customers routinely alleged that the bond investments, because they were speculative and high risk, were not suitable. *See e.g.*, Ex. J. The claimants in arbitration also alleged that Miller & Schroeder violated Municipal Securities Regulation Board rules. *See e.g.*,

Ex. K; and Ex. 4 to Anderson Affidavit at p. 20.

The lawsuits remain pending. Some arbitrations have reached resolution and in each one that has, the result has been an award in favor of the claimants and the arbitrators have, among other things, concluded that Miller & Schroeder failed to supervise its brokers. *See e.g.,* Ex. J. Most of the bondholders have also made claims in the bankruptcy estate. *See* e.g., Ex. K-1.

It appears that Miller & Schroeder, prior to filing for bankruptcy, incurred and paid in legal fees of approximately $735,658.65 defending the various actions and became liable for millions in dollars in damages. Ex. L; *see also* Atmore Aff. at ¶11. Executive Risk has not provided a defense to any of the claims and has not paid any of the awards. The former Miller & Schroeder entities were driven into bankruptcy as a result of the mounting fees and exposure to liability.

Executive Risk has repeatedly admitted that the Heritage Bond claims are "claims" under the Policy. *See e.g.,* Ex. M. The sole basis for denial of coverage has been the two exclusions at issue. Ex. N (Deposition of Joel Townsend) at 45.

D. Executive Risk's Claims Handling and Interpretations of the Policy

It does not appear that there were any claims made under the Policy prior to the 2000 renewal. After the renewal, however, claims were made under the policy that gave Executive Risk, now owned by Chubb, an opportunity to address the securities exclusion and the management carveback. Several claims examiners were involved in addressing the coverage issues.

1. Cheryl O'Malley

In late 2001, a claim was made against Miller & Schroeder arising out of a sale of participations in a casino loan and Miller & Schroeder tendered the claims to Executive Risk for defense and coverage. Ex. O (Deposition of Cheryl O'Malley) at 9-10; *see also* Ex. P (O'Malley Dep. Exs. 1-9). Claims were made in the underlying case against two officers of Miller & Schroeder who had no involvement in the transaction, but who had supposedly failed to supervise the involved employees. *Id*. The claim was assigned to Cheryl O'Malley, a claims examiner in Chubbs' Pittsburgh office. Ex. O (O'Malley Dep.) at 5-6.[5] Ms. O'Malley, a lawyer, discussed the policy language with broker and, when the broker raised the issue of the management carveback and its application to the claims against the officers, Ms. O'Malley struggled with its language. Ex. P at 1-2. Initially, she determined that the claim did not invoke coverage because the officer had some involvement in the underlying transaction. *Id.* at 2. She then decided that she needed to discuss the intent of the carveback with an underwriter. *Id.* at 1. (Note, this was not the underwriter involved in issuing the initial policy.)

The Chubb underwriter responded by indicating that the intent of the carveback was to cover only "vicarious liability" situations. *Id*. Ms. O'Malley then concluded that Executive Risk might have to defend the case with a "reservation of rights." *Id*.

At about this same time, however, the Heritage Bond claims were coming into Executive Risk. Executive Risk soon realized that there were going to be a significant number of these claims. It was decided that all claims would be assigned to Carrie Campi, a claims examiner in

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[5] Ms. O'Malley had no independent memory of her claims handling. Ex. O at 11, 21-23, 25-30, 47. Her contemporaneous notes and letters provide the only evidence of her thought process and claims handling. Ex. P (O'Malley Dep. Exs. 1-9).

Simsbury, CT. *Id*. at 3. Joel Townsend, claims counsel for Chubb, became involved. Ms. Campi and Mr. Townsend had a conference call with Ms. O'Malley in January 2002.[6] None of the participants could recall the conversation, but Ms. O'Malley made a record in her claims notes:

> Conference call with Carrie Campi and Joel Townsend in late Dec to discuss Miller & Schroeder E&O Exclusion; all new claims will go to Carrie in Simsbury. Joel explained that E&O exclusion not intended to carve back E&O for supervisors; **doesn't make sense**.

Id. (emphasis added). *See also* Ex. Q (Deposition of Carrie Campi) at 51-52.

Ms. O'Malley then contacted the broker and told him that a denial of coverage letter would be coming soon. Ex. P at 3. She had the letter reviewed by Mr. Townsend before it was sent. *Id.* The letter was sent a few days later. *Id*. In discussing Endorsement No. 9, Ms. O'Malley first noted that she believed the allegations in the underlying complaint indicated that the subject officer was directly involved in the underlying transaction. She then wrote:

> For the exception to the General E&O exclusion to apply, a Claim must involve allegations of a Wrongful Act *in connection with the management or supervision of* a division, subsidiary of group. The purpose of the exception is clear from this language - a claim against an insured director or officer for breach of duty owed as a manager/supervisor - ...would not be excluded **simply by virtue of the fact that the unit engages in investment banking transactions**.

Id. at p. 8 (italics in original; bold added). In short, Ms. O'Malley believed that the exclusion, as indicated to her by the underwriter, would allow coverage for "vicarious liability" situations. (The coverage is actually broader than that (*See* definition of "Wrongful Act" in the policy).

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[6] By this time, as Executive Risk knew, the former Miller & Schroeder entities were seeking bankruptcy protection.

Before they were consolidated with Ms. Campi, a Heritage Bond claim was assigned to one of the "technical supervisors" at Chubb. Technical Supervisors have more experience than claims examiners. Ex. O (O'Malley Dep.) at 41. The Supervisor wrote a memorandum to the file that includes a discussion of Endorsement No. 9 (referred to as 11) and its application to a claim of "failure to supervise" under the NASD rules. She provided the memo to Ms. O'Malley. Ex. P at 19. The memo is important because it indicates how Executive Risk/Chubb interpreted the securities exclusion and management carveback together and because of how Executive Risk, at that time, interpreted the management carveback. The memo concludes:

> Endorsement No. [9] deals with the management or supervision of a specific division or part of the parent corporation and not employee supervision. Thus, the carveback...is not applicable to this matter and the exclusion for securities claims...serves to exclude this matter.

Id. at 22. Executive Risk, then, recognized that the management carveback would override the securities exclusion.[7] It was only because Executive Risk, incorrectly, decided that the supervision claim was employee specific that it then concluded that securities exclusion would preclude coverage.

2. <u>Carrie Campi</u>

As noted above, the Heritage Bond claims were eventually centralized with Ms. Campi. Her deposition testimony needs to be reviewed in some detail.[8]

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[7] Note that even on this point, Executive Risk is incorrect. As Mr. Fierstein noted, the "Securities Exclusion" is intended to preclude coverage for the insured's sale of the insured's stock. It was not intended as a blanket exclusion for all of Miller Schroeder's activities.

[8] It should also be noted that on October 28, 2004, one day before this memorandum was due and over a month after Ms. Campi's deposition, Executive

Ms. Campi, like Ms. O'Malley and Mr. Townsend, is a lawyer. Ex. Q at p. 7. Ms. Campi started with Chubb in August of 2000. *Id*. In handling the Heritage Bond claims and the subject policy, she indicated that she would review the claim, review the policy, and determine if the claim was, in fact, a claim. *Id*. at 14. She would then look for any exclusions and discuss the claim with her supervisor. *Id*. She may also consult with the underwriter, but she noted that in this case, he was no longer with the company. *Id*. at 17. She noted that it was somewhat unique to see the subject policy with a "financial institution" as the insured, as opposed to a "small family run private business[]." *Id.* at 19 and 22.

In discussing the E&O exclusion, she agreed that in the absence of the exclusion, coverage might be available for E&O claims under the other language of the Policy. *Id*. at 26-27. In discussing the definition of Wrongful Act, she agreed that the officers and directors, as such, could have coverage for E&O claims. *Id*. at 28. She also agreed that the "management carveback" limits the exclusion in Endorsement No. 9. *Id*. at 30-31.

She then explained the reasoning behind Executive Risk's denial of coverage under Endorsement No. 9, by indicating that the allegations did not involve the management or supervision of a division, subsidiary or group, but instead involved the "management of individuals and specific activities. The sale of Heritage Bonds." *Id*. at 33. Ms. Campi said that the carveback might provide coverage for "A shareholders' suit." *Id*. at 36. As long as a customer claim involved a "particular transaction" she did not believe the carveback would

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Risk produced one hundred and thirty pages of new documents, the last of which is a four page document containing Ms. Campi's initial claims handling notes. Ex. R. These notes contradict Ms. Campi's deposition testimony and clearly show that she, like Ms. O'Malley, thought the management carveback would provide coverage.

allow for coverage. *Id*. at 37.

In discussing the fact that the definition of Wrongful Act contains "errors, omissions," Ms. Campi first said that she thought that language was different from "errors and omissions," but then agreed that "It could be the same." *Id*. at 54-55. She also ultimately agreed that "how people interpret [Endorsement No. 9] can be different." *Id*. at 55. She refused to say whether Plaintiff's interpretation of Endorsement No. 9 was or was not reasonable, saying she never considered the question. *Id*. at 57-58.

Ms. Campi then discussed in more detail her current notion of why the carveback would not apply in the Heritage Bond situation. Unlike Ms. O'Malley, Ms. Campi's focus was on the transaction. She concluded that even though there "may have been five different people selling the bonds to different people but only one person was doing the one transaction with whoever they sold the bonds to." *Id*. at 56. She concluded that if the claim involved a "specific sale" there was no coverage, even if the officer or director played no role in the transaction. *Id*. at 59. When pressed as to how that position was consistent with the definition of Wrongful Act, she stated that now the issue was whether the officer or director was "responsible for the liability occurring from whatever wrongful act that occurred with regard to the sales." *Id*. at 60-63. In the end, she could not explain what she meant or whether the officer had to be involved or responsible for the sale. *Id.* at 63-65.

As noted above, Ms. Campi's initial claims handling notes were not produced until long after her deposition. Her comments in those notes are in stark contrast to her deposition testimony and, perhaps, explain why Ms. Campi had difficulty explaining her position at her deposition.

In November 2001, before all the claims were consolidated and before Joel Townsend got involved, the Spanglor Heritage Bond claim was assigned to Ms. Campi. Ex. R. Ms. Campi noted that Mr. Dlugosch was named in the demand for arbitration because he was "M&S CEO and a control person." *Id*. at 1. Ms. Campi then noted:

> Coverage Issues:
>
> The E&O exclusion precludes coverage for Hill and M&S. There is a management carveback that would at least possibly trigger the duty to defend for Dlugosch.

Id. Ms. Campi later spoke with Ken Larson from Miller & Schroeder, telling him Executive Risk would be appointing counsel for Mr. Dlugosch. *Id*.

Ms. Campi, a few days later, realized that there would be more of these claims and that "this account could hit fairly hard." *Id*. at 2. She notified the Chicago office and also sent an email to all other claims examiners. *Id*.

Still later, she comments on the "broad form securities exclusion" and notes that she is "calling the underwriters to discuss the intent between the securities exclusion and the E&O exclusion with a management carveback." *Id*. Ms. Campi discusses the claims with another claims examiner, and notes that the securities exclusion "might be inconsistent with the management carveback..." *Id*.

Soon, though, Ms. Campi has discussed the claims with Joel Townsend, who tells her that all claims are excluded, regardless of any supervision claims. *Id*. (In an email, Ms. Campi notes that Mr. Townsend said "...the intention behind the E&O endorsement carveback was to allow claims for mismanagement as made by shareholders not clients." Ex. S at 2). A conference call is held and it is agreed that Ms. Campi will handle all the claims and that all the

claims will be denied. *Id*.

3. Joel Townsend

Mr. Townsend also testified as to his interpretation of Endorsement No. 9. Mr. Townsend is claims counsel and supervises the claims examiners. He decided that the claims examiners were wrong and that the management carveback did not provide coverage. Mr. Townsend thought that Endorsement No. 9 was clear "on its face." Ex. N at 35, 44. He agreed, though, that absent the E&O exclusion, "others" might conclude that the policy provides some E&O coverage. *Id*. at 38-39, 42. He also agreed that the purpose of the carveback was to limit the exclusion. *Id*. at 46. His conclusion, though, was that the carveback did not bring back into coverage any claims that may be covered under the exclusion in paragraph 1, but instead that the carveback, despite that it lacks any such limiting language, served only to allow coverage for shareholder suits and breach of fiduciary duty claims. *Id*. at 51-52. In other words, unlike Ms. O'Malley and Ms. Campi, Mr. Townsend's focus was on the nature of the activity. If the underlying activity involved one of the three services listed in the exclusion, the carveback did nothing to limit the exclusion. Mr. Townsend, though, did not have an understanding of the specific claims alleged in the Heritage Bond arbitrations and suits. *Id*. at 50-51, 64-65.

Mr. Townsend, however, agreed that if the basis for the claim against the officer or director was simply that they were an officer and director, paragraph 1 of the E&O exclusion would not prevent coverage and there would be no need to look at the carveback. *Id*. at 54-55.

4. Sherri McKelvey

Sherri McKelvey took over the Heritage Bond claims handling from Ms. Campi. Ms.

McKelvey, also a lawyer, started with Chubb in October 2002. Ex. T (Deposition of Sherri McKelvey) at 6, 9. She did not review all of the complaints. *Id*. at 37. Ms. McKelvey concluded, under the guidance of Mr. Townsend, that any and all "E&O claims" are excluded by Endorsement No. 9, regardless of the management carveback. *Id*. at 53. (This appears to be Executive Risk's current position, being advanced in defense of this case). Ms. McKelvey, who started at Chubb five years after Endorsement No. 9 was negotiated and written and who did not talk to the involved underwriter, or any underwriter, then opined as to what Executive Risk intended to do in Endorsement No. 9. *Id*. at 54, and 107-108. She testified, though, that she had no basis for her statement as to the intent behind the Endorsement. *Id*. at 109.

Ms. McKelvey, like Mr. Townsend, also concluded that the carveback essentially had nothing to do with the exclusion. *Id*. at 55, 64. Ms. McKelvey explained that the failure to supervise claims like those made in the Heritage Bond cases were not covered because "it's not with respect to the management of the company, it's the management of those securities." *Id*. at 59-61.

Ms. McKelvey's position led her to admit that in the Heritage Bond cases "there are certainly allegations for management of the group." *Id*. at 67-68. She also agreed that the officers and directors were not alleged to have individually sold the securities. *Id*. at 68. For Ms.

McKelvey, though, that fact did not matter, as the claims involved the listed services and "improper securities." *Id*. at 67-68.

Despite that she had earlier testified that Endorsement No. 9 does not cover errors and omissions claims, Ms. McKelvey, when presented with the definition of Wrongful Act and its

inclusion of "errors, omissions", decided that some "errors" would be covered. *Id*. at 102. She could not remember reading the definition or other parts of the Policy. *Id*. at 104-106.

ARGUMENT

The Policy provides coverage for the Heritage Bond claims made against the Miller & Schroeder entities and the officers and directors for failure to supervise the Solano Beach office and the Sales Division of the Company. Executive Risk was obligated to provide a defense and to pay any resulting awards or judgments.

Neither of the two exclusions eliminate coverage. The "Securities Exclusion" does not defeat coverage. A complete reading of the Policy, the claims handling notes, and Mr. Fierstein's testimony all lead to the conclusion that the exclusion is intended to exclude only claims based on sales of stock by the company and its officers and directors, and not the brokering of securities. As the Executive Risk claims examiners realized, moreover, there is conflict between the securities exclusion and the management carveback. Endorsement No. 9, meanwhile, far from precluding coverage, expressly preserves coverage for the Heritage Bond claims.

I. STANDARD FOR SUMMARY JUDGMENT

Bankruptcy Rule 7056 provides that Rule 56 of the Federal Rules of Civil Procedure applies in adversary proceedings in bankruptcy cases. Rule 56 states:

> That judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

Summary judgment plays a very important role in the judicial proceedings by allowing the judge to "pierce the pleadings and to assess the proof in order to see whether there is a genuine need for trial." Fed. R. Civ. P. 56, Advisory Committee note. Summary judgment is properly regarded not as a disfavored procedural shortcut, but rather as an integral part of the federal rules as a whole, which are designed "to secure the just, speedy and inexpensive determination of every action." *Celotex Corp. v. Catrett*, 477 U.S. 317, 327 (1986).

The initial burden is on the party seeking summary judgment. To that end, the movant discharges its burden by showing that the record does not contain a triable issue and by identifying that part of the record which supports the moving party's assertion. *Id.*, 477 U.S. at 323; *City of Mt. Pleasant, IA v. Assoc. Electric Co-op, Inc.* 838 F.2d 268, 273 (8th Cir. 1988). Once the movant has made its showing, the burden of production shifts to the non-moving party. The non-moving party must present specific, significant and probative evidence supporting its case, *Johnson v. Enron Corp.*, 906 F.2d 1234, 1237 (8th Cir. 1990), which is sufficient enough "to require a judge to resolve the parties' different versions of the truth at trial." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986) (quoting *First National Bank of Arizona v. Cities Service Co.*, 391 U.S. 253, 288-89 (1968)).

II. APPLICABLE RULES FOR CONSTRUING THE POLICY

It is “settled law in Minnesota” that the Policy must be construed as a whole and any doubts about the meaning of its language resolved in favor of the insured. *Sphere Drake Ins. PLC v. Trisko,* 24 F.Supp.2d 985, 991 (D. Minn. 1998); *See also Watson v. United Services Automobile Association,* 566 N.W.2d 683,692 (Minn. 1997); *Henning Nelson Constr. Co. v. Firemans’ Fund Amer. Life Ins. Co.,* 383 N.W.2d 645,652 (Minn. 1986); *Canadian Universal*

Ins. Co., Ltd. v. Fire Watch, Inc., 258 N.W.2d 570, 572 (Minn. 1977). Any ambiguity is construed against the insurer. *Sphere Drake,* supra at 991. *See also American Commerce Ins. Brokers, Inc. v. Minnesota Mut. Fire and Cas. Co.,* 551 N.W.2d 224, 227 (Minn. 1996). Exclusions, in particular, are strictly construed against the insurer and when a claim is arguably within the policy's coverage, the insurer must prove that the exclusion applies. *Sphere Drake,* supra at 992 *citing Columbia Heights Motors, Inc. v. Allstate Ins. Co.,* 275 N.W. 2d 32, 35 (Minn. 1979); *Caledonia Community Hosp. v. St. Paul Fire & Marine Ins. Co.,* 307 Minn. 352, 354, 239 N.W.2d 768, 770 (Minn. 1976).

Where, as here, the policy includes a duty to defend, the insurer also has the obligation to establish that no claim even arguably fits within the coverage provided by the policy, because the duty to defend is broader than the duty to indemnify. *Meadowbrook, Inc., et. al. v. Tower Insurance Company, Inc.*, 559 N.W.2d 411, 415 (Minn. 1997). If any one of multiple claims involves coverage, the insurer must defend the entire case. *See Brown v. State Auto. & Cas. Underwriters,* 293 N.W.2d 822 (Minn.1980). *See also, U.S. Fidelity and Guaranty Co. v. Louis A. Roser Co., Inc.,* 585 F.2d 932 (8th Cir. 1978). As the Court suggested in *Piper Jaffray Companies, Inc.*, when the task involves determining and giving effect to the parties' intent, the Court must look to both the circumstances surrounding the purchase of the Policy and any subsequent interpretations of the Policy by the parties. *Id*. at 1154.

III. THE POLICY PROVIDES COVERAGE FOR THE HERITAGE BOND CLAIMS.

The Policy provides coverage for the Heritage Bond claims. Executive Risk agrees that the Heritage Bond claims are "Claims" under the policy and also agrees that the Miller & Schroeder entities and the officers and directors are "Insureds." The focus, then, is the

"Management Carveback." It is Executive Risk's burden to prove that an exclusion applies and, regarding the duty to defend, to prove that no claims are even arguably covered. Executive Risk cannot make the required showing.

An understanding of the carveback begins with the definition of "Wrongful Act." As noted above, the definition of Wrongful Act includes:

> (2) any other actual or alleged act, error, omission, misstatement, misleading statement or breach of duty by an Insured Person in his capacity as a director or officer of the Company;
>
> (3) any matter asserted against an Insured Person solely by reason of his or her status as a director or officer of the Company;...

Ex. H at 5. An officer or director, then, that commits an error or omission or breach of duty commits a Wrongful Act. If a claim is made against an officer or director solely because he or she is an officer or director, that officer or director has also committed a Wrongful Act. The Policy provides coverage for losses arising out of Wrongful Acts.

The first paragraph of Endorsement No. 9, takes out of coverage a Wrongful Act as defined in paragraph (2) above, as the endorsement excludes claims involving the actual or alleged rendering of the listed services, to the extent that the officer or director has actually or allegedly rendered those services. The carveback, however, leaves in coverage a Wrongful Act as defined in paragraph (3) above, if the "...Wrongful Act [is] by an Insured Person in connection with the management or supervision of any division, Subsidiary or group of the Parent Corporation offering any..." of the listed services.

The language of Endorsement No. 9, then, allows for coverage if the insured is not involved in the actual or alleged rendering of the listed services or if the claim alleges errors, omissions, or breach of duty in managing or supervising a division, subsidiary or group. In other

words, the Policy contemplates coverage for claims against officers and directors arising out of their status as officers or directors or if they commit an error or omission or breach of duty in the exercise of their responsibilities as an officer or director. The Heritage Bond claims made against the company and the officers and directors fit squarely within the coverage provided.

The Heritage Bonds were underwritten and sold by Miller & Schroeder Financial, a subsidiary of Miller & Schroeder. *See* Ex. K. The vast majority of the sales were made through brokers in the Solano Beach, CA sales office. As Ms. McKelvey admitted, the allegations against the officers and directors relate to the management or supervision of a group. The allegations against the officers and directors, moreover, are either for "control person" liability or relate to the alleged failure to implement a system of supervision. The control person liability is based on the status of the officer or director and, thus, the claim is a covered claim under the Policy. The failure to supervise claims are based on the status of the officer or director and/or on the fact that the officer or director was a member of the Credit Committee.

As noted by Mr. Dlugosch and Mr. Nelson, it was the intent of the parties to cover Heritage Bond type claims. That such coverage would be provided was critical, according to Mr. Dlugosch, in MI Acquisitions' decision to purchase the policy. Neither the Executive Risk underwriter, Mr. Watts, nor the wholesale broker, Mr. Fierstein, had any recollection regarding the issuance of the policy. Subsequent interpretations of the policy by Executive Risk, as detailed above in the discussion of the claims handling by Chubb personnel, makes clear that the Chubb claims examiners, all of whom were lawyers, read the carveback as allowing coverage. It was not until Chubb realized that the policy might be "hit fairly hard" and Mr. Townsend became involved that Executive Risk decided the carveback provided no coverage. Prior to that,

Ms. O'Malley and Ms. Campi and other claims examiners were prepared to provide a defense to Mr. Dlugosch and to agree that the carveback allowed coverage.

The evidence shown in the claims handling notes, moreover, establishes not only that there should be coverage, but that the insureds (Miller & Schroeder and its officers and directors) had every reasonable expectation of coverage. *See Josten, Inc. v. Northland Ins. Co.*, 527 N.W.2d 116 (Minn. Ct. App. 1995) (Doctrine of reasonable expectations protects insureds objectively reasonable expectations). While Ms. Campi refused to say whether she thought the insureds' interpretation was reasonable, her claims handling shows that she had the same interpretation.

These claims are covered by the Policy. Executive Risk had a duty to defend the claims and to cover any loss arising from the claims.

IV. THE EXCLUSIONS DO NOT DEFEAT COVERAGE

Executive Risk cannot meet its burden or proving that the two exclusions it has raised in denying coverage actually defeat coverage.

A. The Securities Exclusion Does not Defeat Coverage

Endorsement No. 3, the "Securities Exclusion" does not, for several reasons, defeat coverage. First, in the context of the entire Policy, the exclusion must be read as only excluding from coverage claims made against insureds relating to sales of company stock. Second, the exclusion does not mention NASD claims (or Municipal Securities Regulation Board claims) and, therefore, such claims are not excluded. Third, the exclusion is contradicted, and rendered ambiguous, by other language in the Policy.

The application of the Securities Exclusion was fully briefed and argued in the context of

Executive Risk's prior motion to dismiss. The detailed arguments set forth in Plaintiff's prior memorandum opposing that motion and the arguments made at the hearing on that motion will not be repeated here (but are incorporated herein by reference). Several facts brought to light during discovery, however, should be highlighted.

First, Mr. Fierstein, from ARC, confirmed during his deposition that Plaintiff's interpretation of the intent of the Securities Exclusion was correct. The purpose of the exclusion is to preclude coverage for claims arising from the sale of company stock. *See Quinlivan v. EMCASCO Ins. Co.*, 414 N.W.2d 494, 497 (Minn.Ct. App. 1987), citing *Taylor v. Security Mutual Fire Insurance Co.,* 88 Minn. 231, 92 N.W. 952 (1903) (Court can look to insurance industry trade usage in determining the meaning of policy language).

Second, the claims handling notes quoted above, and in particular Ms. Campi's claim handling notes, make clear that even Executive Risk recognized inconsistency between the Securities Exclusion and the management carveback. The problem arises from the fact that Miller & Schroeder was in the securities business. To exclude all claims that implicate securities law violations simply does not make sense.

B. <u>The E&O Exclusion Does Not Defeat Coverage</u>

Endorsement No. 9 cannot defeat coverage. To the contrary, as discussed above, the management carveback allows coverage for the Heritage Bond claims. Executive Risk's position, as expressed by Mr. Townsend, contradicts the language of the endorsement and is inconsistent with other language in the Policy.

Mr. Townsend's position is, essentially, that the carveback does not allow coverage for

claims that arise out the provision of listed services, but instead only allows claims wholly unrelated to the listed services. In fact, Mr. Townsend insists that the only claims allowed in by the carveback would be shareholder claims and employment claims. Mr. Townsend is incorrect for several reasons.

First, there is no such limitation of the carveback on the face of the endorsement. Had Executive Risk wanted to so limit the carveback, it could have easily included language to the effect that only shareholder claims and employment claims would result in coverage.

Second, Mr. Townsend's interpretation is contrary to everyone else's reading of the endorsement. Each Chubb claims examiner reading the policy before speaking to Mr. Townsend believed it allowed, to some extent, coverage and that it was not limited as Mr. Townsend suggests.

Third, employment claims are addressed, extensively, elsewhere in the policy as are shareholder claims. Ex. H at 3-6. Not only would Mr. Townsend's interpretation render the carveback redundant, but, again, had Executive Risk wanted to limit the carveback it could have easily included a reference to the sections of the policy dealing with employment claims and shareholder suits and could have used the defined terms found in those sections of the policy.[9]

CONCLUSION

The claims made by the Heritage Bond bondholders invoke the promise of coverage given in paragraph I(B), quoted above, and the promise of coverage given in the "management carveback" under Endorsement No. 9 and come within the definition of "Wrongful Act" found in

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[9] For example, Endorsement No. 8 refers specifically to the term "Employment Practices Wrongful Act" and includes it in the definition of "Wrongful Act" for the purposes of that endorsement.

paragraph II(M)(2) and (3) of the Policy. The claims arise directly out of the business of Miller & Schroeder and out of the rendering of the services listed in Endorsement No. 9, and are the reason that Miller & Schroeder needed the policy it purchased.

For the reasons set forth above, the Trustee respectfully requests that the Court grant his motion in its entirety.

LEONARD, O'BRIEN
SPENCER, GALE & SAYRE, LTD.

Dated: October 30, 2004

By /e/ Thomas C. Atmore

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UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re:	Chapter 7 Case
SRC Holdings Corporation, f/k/a Miller & Schroeder, Inc. and its subsidiaries,	BKY Case Nos. 02-40284 to 02-40286 Jointly Administered
Debtor.	
Brian F. Leonard, Trustee,	ADV Case No. 03-4284
Plaintiff,	
v.	
Executive Risk Indemnity, Inc.	
Defendant.	
The Marshall Group, Inc., Jerome A. Tabolich, James E. Iverson, Edward J. Hentges, Kenneth R. Larsen, Steven W. Erickson, Paul R. Ekholm, and Mary Jo Brenden,	
Intervenors.	

AMENDED AFFIDAVIT OF THOMAS C. ATMORE IN SUPPORT OF A PARTIAL SUMMARY JUDGMENT MOTION

Thomas C. Atmore, under penalties of perjury states as follows:

1. I am a shareholder at Leonard, O'Brien, Spencer, Gale & Sayre, Ltd., counsel for Plaintiff in the above-captioned matter and have personal knowledge of the facts stated herein.

2. Attached hereto as Exhibit A is a true and correct copy of selected pages from the Deposition of James F. Dlugosch.

3. Attached hereto as Exhibit B is a true and correct copy of selected pages from the Deposition of Richard Fierstein.

4. Attached hereto as Exhibits C, D, E, F, G are true and correct copies of selected pages from the Deposition of Michael Watts and select exhibits thereto.

5. Attached hereto as Exhibit H is a true and correct copy of the POWER Policy for policy period 2000-2003.

6. Attached hereto as Exhibit I is a true and correct copy of selected pages from the Deposition of Tom Nelson.

7. Attached hereto as Exhibit J is a true and correct copy of the *Second Amended Statement of Claim* in *Onderwyzer, et al. v. Miller & Schroeder Financial, Inc., et al.*

8. Attached hereto as Exhibit J1 is a true and correct copy of an NASD Award in *In re: Lundquist Family Trust*.

9. Attached hereto as Exhibit K is a true and correct copy *Statement of Claim* in *Edge v. Miller & Schroeder Financial, Inc.*

10. Attached hereto as Exhibit K1 is a true and correct copy the Baker Living Trust Proof

of Claim.

11. Attached hereto as Exhibit L is a true and correct copy the summary of the invoices from the Arthur, Chapman and Faegre & Benson law firms for defense of Heritage Bond claims (invoices voluminous and not attached).

12. Attached hereto as Exhibit M is a true and correct copy letter dated May 12, 2003 from Sherri McKelvey to Thomas C. Atmore.

13. Attached hereto as Exhibit N is a true and correct copy of selected pages from the Deposition of Joel Townsend.

14. Attached hereto as Exhibits O and P are true and correct copies of selected pages from the Deposition of Cheryl O'Malley and exhibits thereto.

15. Attached hereto as Exhibit Q, R and S are true and correct copies of selected pages from the Deposition of Carrie Campi and Ms. Campi's claims handling notes produced by Executive Risk on October 27, 2004.

16. Attached hereto as Exhibit T is a true and correct copy of selected pages from the Deposition of Sherri McKelvey.

Signed under penalties of perjury.

Dated: October 30, 2004 By /s/ Thomas C. Atmore

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UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re:	Chapter 7 Case
SRC Holdings Corporation, f/k/a Miller & Schroeder, Inc. and its subsidiaries	BKY Case Nos. 02-40284 to 02-40286 Jointly Administered
Debtor.	
Brian F. Leonard, Trustee,	ADV Case No. 03-4284
Plaintiff,	
v.	
Executive Risk Indemnity, Inc.	
Defendant.	
The Marshall Group, Inc., Jerome A. Tabolich, James E. Iverson, Edward J. Hentges, Kenneth R. Larsen, Steven W. Erickson, Paul R. Ekholm, and Mary Jo Brenden,	
Intervenors.	

UNSWORN CERTIFICATE OF SERVICE

I, Thomas C. Atmore, declare under penalty of perjury that on the 30th day of October, 2004, I mailed, emailed and faxed a copy of the annexed ***Amended Notice of Hearing and Motion for Partial Summary Judgment; Plaintiff's Amended Memorandum in Support of Motion for Partial Summary Judgment;*** *and* ***Amended Affidavit of Thomas C. Atmore in Support of a Partial Summary Judgment Motion*** on

VIA EMAIL, FACSIMILE (202-719-7049) AND U.S. MAIL

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by mailing, emailing and faxing to all parties copies thereof, and, in the case of the U.S. Mail, enclosed in an envelope, postage prepaid, and by depositing the same in the post office at Minneapolis, Minnesota, directed to said parties at the last known addresses of said parties.

Dated: October 30, 2004

s/ Thomas C. Atmore
Thomas C. Atmore

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